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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming	)))))	CS Docket No. 95-61

REPLY COMMENTS

BellSouth Telecommunications, Inc., ("BellSouth") hereby submits this reply to comments filed in response to the Commission's Notice of Inquiry.[1]

Conspicuous by its absence from NCTA's chronicle of the sources of growing competition to cable (satellite, telco, wireless and broadcast) is cable itself; that is, competition from cable system overbuilders.[2] In fact, local multichannel video distribution remains highly monopolistic, and the remedies thus far enacted under the 1992 Cable Act have failed to substantially improve the position of consumers.[3]

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[1] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming,* Notice of Inquiry, CS Docket No. 95-61, FCC 95-186 (rel. May 24, 1995).

[2] Comments of the National Cable Television Association, Inc., pp. 4-18.

[3] Thomas W. Hazlett, *Report on Franchising as a Barrier to Competition*, pp. 1-9, para. 1-6 (July 20, 1995)(hereinafter "*Franchise Barriers*"; original report filed with these Reply Comments as "Attachment A").

Jones Cable Partners at least acknowledges an "apparent lag in the development of multiple franchising" and postulates one explanation:

> . . .new competitors may be intimidated by franchise obligations that cable operators have satisfied for decades; the requirements to provide PEG access channels, to pay significant franchise fees, to install institutional networks, and to make a variety of other concessions may prove to be the most significant obstacle to the development of local cable television competition.[4]

In fact, the structure of local franchise regulation is not only intimidating to new entrants but it is inherently anticompetitive because it levies a large and asymmetric burden of proof upon the new entrant applying for a chance to compete.[5] Dr. Hazlett demonstrates that the cable industry uses the franchising process as a means to impose expensive and burdensome requirements such as universal service obligations on upstart competitors, a strategy described at cable industry seminars as specifically designed to deter overbuilders.[6] The public benefits that are supposed to flow from captured rents, such as PEG and leased access channels, have largely not been realized.[7]

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4 Comments of Jones Cable Partners, L.P. at 12.

5 *Franchise Barriers* at 9-20, para. 7-23.

6 Id., *see especially* pp. 14-16, para. 14-16.

7 Id. at 17-18, para. 18.

When burdensome franchise requirements cannot be imposed on competitors who are not overbuilders, the incumbent cable operator cloaks itself in the protectionist mantle of beneficent franchise regulation and appeals directly to consumers in order to discourage competition. Last month Time Warner Cable wrote residents of a New York City multiple dwelling unit whose Board of Directors voted to change it cable television service provider:

> . . .
>
> <u>YOUR CHOICES</u>: You have three choices: (1) You can maintain your current Paragon Service; (2) You can sign a bulk agreement with Liberty Cable, an unregulated operator; or (3) You can sign a bulk agreement with Paragon Cable, a regulated operator under terms approved by the City and State of New York. . .
>
> . . .
>
> REGULATORY PROTECTION: As a franchised cable operator, Paragon customers benefit from the regulatory protection provided by those agencies of the City and State of New York which have the responsibility of making sure Paragon adheres to strict standards of technical, customer service billing and other issues. Customers have no such protection with Liberty because it is unfranchised and claims to be outside the jurisdiction of the State and City, which are your local regulators.
>
> Finally, it must be said that the tenants of 15 West 81st St. have a stake in New York City as taxpayers and citizens who benefit and contribute to its energy and vibrancy. Because Paragon is a franchised operator, it pays a 5% franchise fee to New York City; Liberty pays no franchise fee. Paragon Cable also provides cable service to public schools, fire stations, police stations, public institutions and government offices -- free of charge. Liberty provides none of these services. Time Warner Cable has built public access studios and municipal studios for citizen and City programming and supports them

> continually. Liberty provides no such support. And Paragon Cable provides universal service throughout its franchise area, making cable available to the poorest neighborhoods, and is specifically prohibited from "redlining" or "cream-skimming." Liberty has no such universal service obligation and is free to cater to only the City's wealthier residents.
>
> As you consider this matter, we hope very much you will keep in mind <u>all</u> the advantages which Paragon Cable offers your members as well as our civic contribution to the whole community.
>
> . . .[8]

The letter is intended to persuade consumers that it is safer (indeed, it is their civic duty) to purchase video programming from the incumbent franchised cable television service provider.[9] In any event, the typical consumer cannot afford to rationally undertake an investigation of the issues involving the local supply of video services.[10] Thus the local franchise obligation is invoked to deter new entrants who are not even subject to its requirements.

The comment period in this docket closes five years after the Commission's seminal recommendation to Congress:

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[8] June 2, 1995 letter from Richard Aurelio, Time Warner Cable to Customer of Paragon Cable, pp. 1, 3, 4, 5, Exhibit E to Comments of Liberty Cable (emphasis in original).

[9] Ironically, there is no mention of rights-of-way in Time Warner's recitation of the regulatory benefits afforded by cable franchises. As Dr. Hazlett notes, the great bulk of the standard cable television franchise contains issues unrelated to the use of public rights-of-way, the ostensible reason a cable franchise is required by local government. *Franchise Barriers* at 19-20, para. 21-22.

[10] *Id.* at 18, para. 19.

> We recommend that Congress amend the Cable Act to forbid local franchise authorities from unreasonably denying a franchise to applicants that are ready and able to provide service. Congress should also make it clear that local authorities may not pass rules whose intent or effect is to create unreasonable barriers to the entry of potential competition multichannel video providers. Franchise requirements should be limited to appropriate governmental interests, such as establishing requirements concerning public health and safety, repair and good condition of public rights-of-way, and the posting of an appropriate construction bond. We also recommend that Congress amend Section 623(a)(3) of the Cable Act to permit competitive entrants to enter a market already served by a cable system without the obligation to provide "universal service" for an initial and limited period of time following their entry into the market.[11]

Thus, the Commission has long advocated at least the mitigation of the universal service component of local franchise requirements that Time Warner has waived as a protectionist flag in the face of its customers and would-be competitors.[12] This, and all elements, of the Commission's 1990 recommendations to Congress remain relevant today.

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[11] *In the Matter of Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service*, MM Docket No. 89-600, 67 Rad. Reg. 2d (P&F) 1771, 1806 para. 141 (Jul. 31, 1990). In the footnote that is omitted from text quoted above, the Commission made the important point that cable operators have significant first amendment rights, and that limiting the franchising authorities' powers to regulating only those matters of traditional local concern would serve first amendment goals as well as remove significant obstacles to competition at the local level. Id. at n. 200.

[12] *Supra* n. 3 and accompanying text. The Commission's recommendation of a limited repeal of the universal service obligation may not be enough to encourage facilities-based competition. *Franchise Barriers* at 14-17, para. 14-17.

CONCLUSION

The Commission has a long-standing policy of not subjecting non-dominant new entrants in telephone service markets to the same extensive regulatory requirements imposed on local exchange carriers. The same treatment should be accorded new entrants in multichannel video programming markets. Excessive, duplicative and unnecessary regulation at all levels, and most particularly at the local franchise level, should be eliminated in order to encourage competition.

RESPECTFULLY SUBMITTED,

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July 28, 1995

REPORT ON CABLE FRANCHISING AS A BARRIER TO COMPETITION[1]

Thomas W. Hazlett[2]

28 July, 1995

1. The Federal Communications Commission's 1994 Report on the Status of Video Competition[3] makes it abundantly clear that, despite the measures enacted pursuant to the Cable Consumer Protection and Competition Act of 1992, local multichannel video distribution remains highly monopolistic. The most direct evidence is yielded by the q ratios.[4] Despite the imposition of three rounds of basic cable rate rollbacks concluding in July 1994, the FCC's estimate of the mean cable industry q ratio remained at between 3.95 and 5.23.[5] As the First Report was forced to conclude: "the current q ratios suggest that, overall, cable television operators possess substantial market power."[6]

2. This evidence of "substantial market power" includes both the impact of fully-implemented rate regulation and information concerning the introduction of direct broadcast satellite services (DBS) in 1994. Estimated q ratios are, in fact, derived from capital market data which

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1 Attachment to Reply Comments of Bell South in: FCC Proceedings, CS Docket No. 95-61 "Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming."

2 A brief biography is attached to this report.

3 *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, "First Report," CS Docket No. 94-48, 9 FCC Rcd 7442 (1994).

4 Where q = [market value]/[replacement cost of tangible capital]. A q in excess of one is evidence of above-normal profitability. See First Report, ¶ 205 - 212.

5 First Report, Table 5.2.

6 Ibid., ¶ 212.

incorporate investor expectations about future cash flows, including the volatility (or riskiness) thereof. While some of the FCC's market value estimates were based on 1993 data, those based on 1994 data continued to indicate the presence of "substantial market power." Moreover, the trend in the intervening months is favorable to cable values, indicating that investors are not expecting recent competition in the marketplace (such as from DBS) to significantly diminish cable system profitability. Since June 1994, when the most recent private market data in the First Report were collected, cable system values have increased substantially. While the private market value for U.S. cable systems was taken from just six cash transactions reported in a trade journal (*Cable World*, 27 June, 1994; pp. 1, 36), and estimated to be $1759 per subscriber, a more complete picture is given in Table 1 of this report. It shows that the mean value per subscriber, according to all 64 reported cable system sales in 1994 (involving over seven and one-half million subscribers), was $1869. In the first three months of 1995, the figure fell only slightly, to $1861 per sub (based on 23 system sales involving 4.7 million subscribers). Hence, the combined impact of rate regulation and competitive entry, which had not eliminated "substantial market power" for cable operators in the FCC's report last year, appear to have even less influence — as demonstrated by investor demand — today.

Table 1
Cable System Values, 1982-95

Year	No. Traded	Basic Subs	Homes Passed	Total Value millions	Value/Sub
1982	212	934,071	1,772,204	$861.6	$922
1983	256	2,631,190	4,874,372	2,699.4	1,026
1984	295	3,023,144	5,506,075	2,865.1	948
1985	356	7,992,899	14,749,733	8,053.8	1,008
1986	620	6,797,164	12,416,229	9,100.8	1,339
1987	498	6,506,466	11,845,227	11,209	1,723
1988	596	7,596,344	13,091,554	15,214.2	2,003
1989	379	5,951,353	10,866,334	13,631.8	2,291
1990	105	531,207	870,588	1,074.6	2,049
1991	111	4,523,433	8,416,685	7,797.4	1,795
1992	97	1,878,754	3,248,086	3,274.9	1,765
1993	96	3,852,668	6,616,887	8,322.6	2,160
1994	64	7,504,177	12,492,997	14,025.3	1,869
1995*	23	4,703,594	7,420,414	8,752.2	1,861

Source: Paul Kagan Associates, *Cable TV Investor* (31 January, 1995; 30 April, 1995).
*Through March.

3. The bottom line is that the measures introduced in the Cable Act of 1992 have not solved the problem for which they were formally intended: The elimination of monopolistic behavior by local cable television systems. Given that rate regulation has already been implemented, there is but one policy alternative to correct this continuing consumer problem: Enhancing, or liberating, competitive market forces. There is little question that where competitive entry into local cable markets occurs, rates charged consumers fall substantially.[7] Moreover, output expands, as more people subscribe to cable and as more channels are typically offered by competitive cable

[7] The Commission has itself found a competitive price differential of 17% ("In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act — Rate Regulation, Buy — Through Prohibition — Third Report and Order," MM docket 92-266 and MM Docket 92-262 [Adopted 22 February, 1994]).

television systems. As an example of the output enhancing impact of competitive entry, take the case of Montgomery, Alabama. There an overbuilder obtained a second franchise, and began competing with the incumbent operator (TCI) in 1991. Currently, the entrant serves about 9,200 subscribers, enjoying a 40% penetration rate (pen = subs/homes passed). The incumbent operator estimates that it has lost some 3,700 subscribers to the entrant, meaning that the new rival has increased total subscribership in its portion of the market by 5,500 households — 24% of homes passed.[8] This enhanced output is strongly indicative of the pro-consumer effect of competition: Subscribers, voting with their own dollars, are demonstrating that the competitive product is preferred to the monopolistic alternative.

4. The evidence is strong that competitive systems not only enhance output in terms of the number of subscribers served but in the number of channels delivered. In the data from competitive and monopoly systems collected by the Commission pursuant to the 1992 Cable Act, it was observed that competitors provided substantially more channels of basic service (Table 2). Most striking is the difference in satellite network programming: While monopoly systems in the FCC sample averaged 8.02 such channels on the basic tier, firms facing direct competition offered a mean of 13.4 — a difference statistically significant at the 99% confidence level. Overall, basic cable packages typically featured about 25.5 channels in competitive markets, just 19.1 on monopolies. Total channels offered by competitive systems averaged 44.25, or 27% more than the mean number of offered by monopoly systems.

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8 Debbie Narod, "Overbuilds '95," *Cable World* (1 May, 1995), pp. 46-49; p. 47.

Table 2

Channel Carriage on Competitive and Monopoly Cable Systems in 1992

FCC Data

Variable	Monopoly Franchises (n = 440)	Overbuild Sample (n = 55)
Basic Tier Characteristics		
Local TV broadcast stations	6.72	6.6
Distant TV broadcast stations***	2.36	3.71
Satellite cable network channels***	8.02	13.4
Public educational/gov't. access channels	1.24	1.24
Total channels***	19.07	25.51
Second Tier Characteristics		
Local TV Broadcast stations	0.07	0.04
Distant TV broadcast stations	0.29	0.54
Satellite cable network channels	9.21	10.07
Public educational/gov't. access channels	0.09	0.13
Total channels	9.89	11.05
All Channels in the Franchise Area		
Total pay channels***	4.16	5.13
Total pay-per-view channels***	0.74	1.28
Total channels***	34.92	44.25

*,**,*** indicate differences that are significant at the 90%, 95%, and 99% confidence levels, respectively

Source: Jennifer Fearing and Charles Lubinsky, "Qualitative Differences in Competitive Cable Markets: A Report to the National Telecommunications and Information Administration." (Harvard University: John F. Kennedy School of Government; 11 April 1994), p. 42.

5. Competition is still an all-too-rare occurrence. This is seen in the Commission's 1994 conclusions about the dearth of competitive cable markets,[9] and implicitly revealed in the q ratio estimates. Further evidence that competitive pricing has not been the result of the 1992 Cable Act is seen in the pattern of industry subscriber growth. Were prices constrained by regulation or competition, as a result of the Act, then output should demonstrably increase in

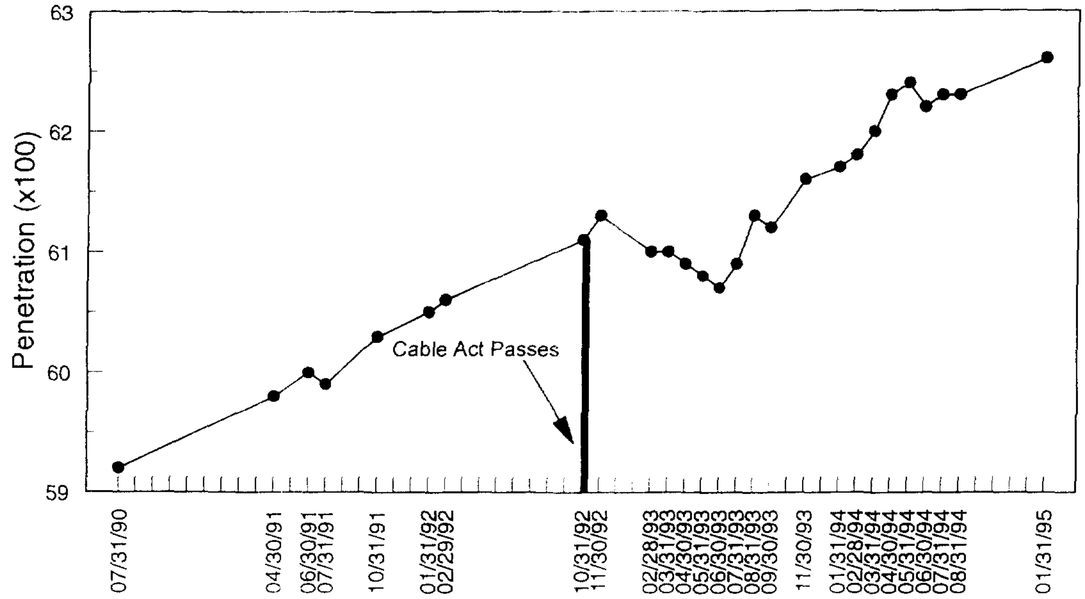
9 First Report, ¶ 15.

Figure 1

US CABLE PENETRATION DURING REREGULATION

Top 100 MSOs

July 1990 - January 1995



Source: Paul Kagan Associates, Cable TV Investor (various issues)

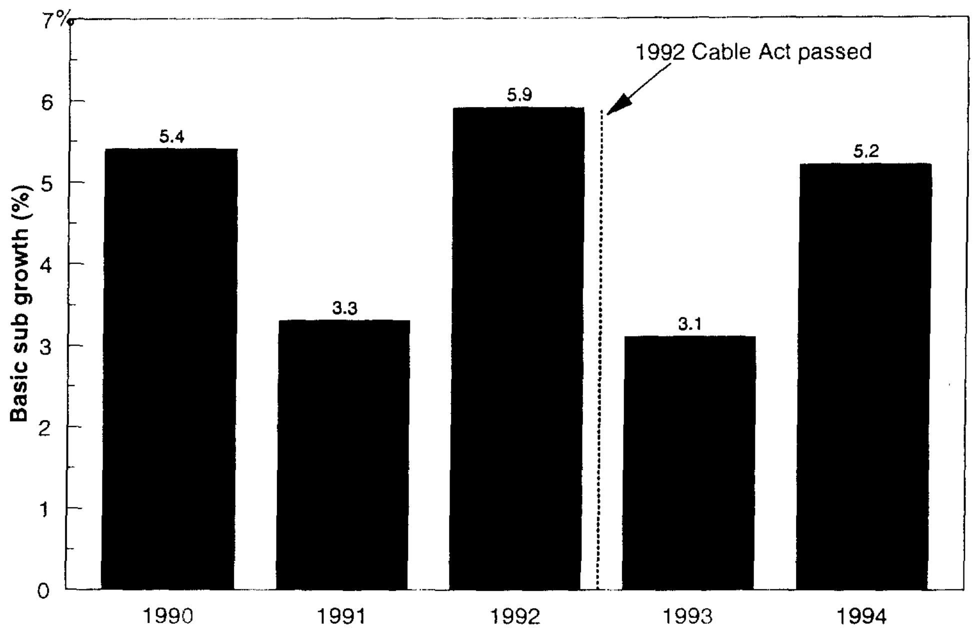
the period following enactment. Yet, despite an economy growing during recovery, the evidence is clear that there has been no spurt in cable subscribership trend during the period following the Cable Act of 1992. Figure 1 shows the growth in mean cable penetration for cable systems owned by the top 100 MSOs (multiple system operators) in the July 1990 to January 1995 period. In the 27 months prior to the Cable Act (enacted in October 1992), penetration actually grew at a faster rate (about 3.2%) than in the 27 months post-Act (2.5%). Similarly, basic cable subscriber growth (Figure 2) for the top 100 MSOs shows that in the two years following the Cable Act, annual percentage gains (September 1990 to September 1992) decline. This familiar pattern is again seen in A.C. Nielsen penetration data collected from cable operators. From November 1990 to November 1992, the closest reported mapping of the before and after Cable Act periods, national penetration increases 2.6% (Figure 3). In the November 1992 to November 1994 period,

Figure 2

Increase in Basic Subscribers, September to September

Top 100 MSOs

1990 - 1994



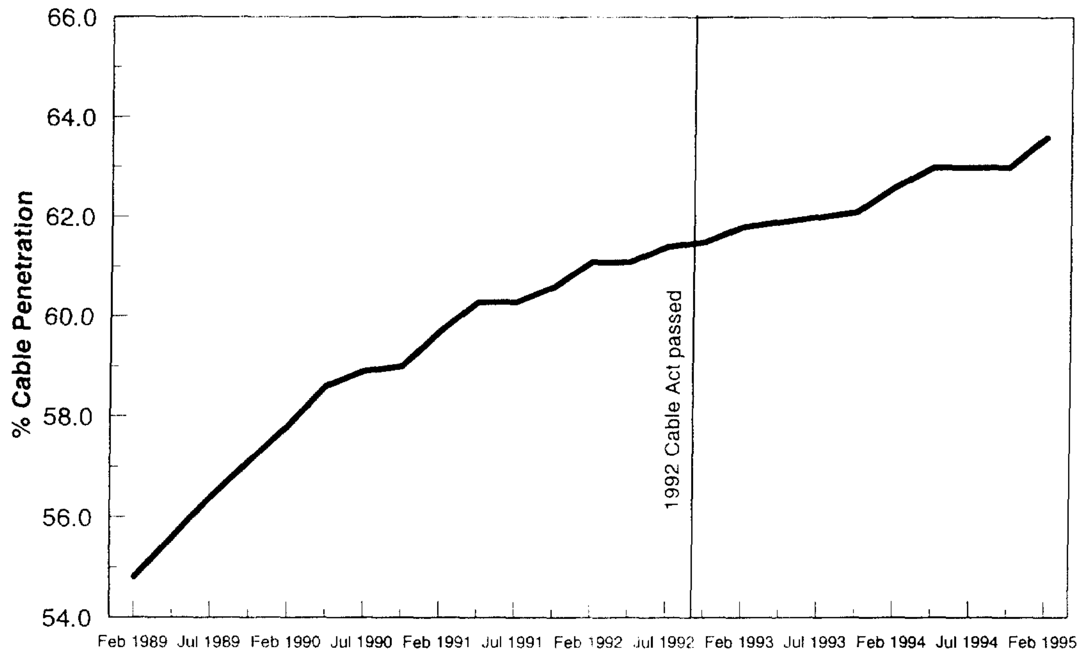
Source: 1995 Paul Kagan Associates, Inc

Figure 3

Cable Penetration Trend

Reported by Nielsen Official Universe (Cable TV Operator Data)

Feb 1989 - Feb 1995



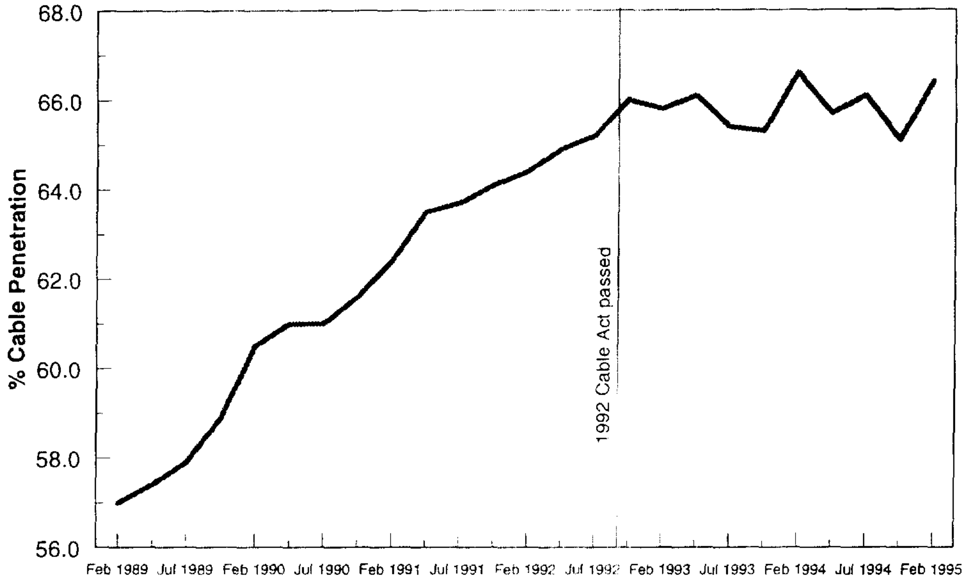
Source: Nielsen Media Research.

Figure 4

Cable Subscribership Growth

Nielsen People Meter Universe (4,000 TV Home Panel)

Feb 1989 - Feb 1995



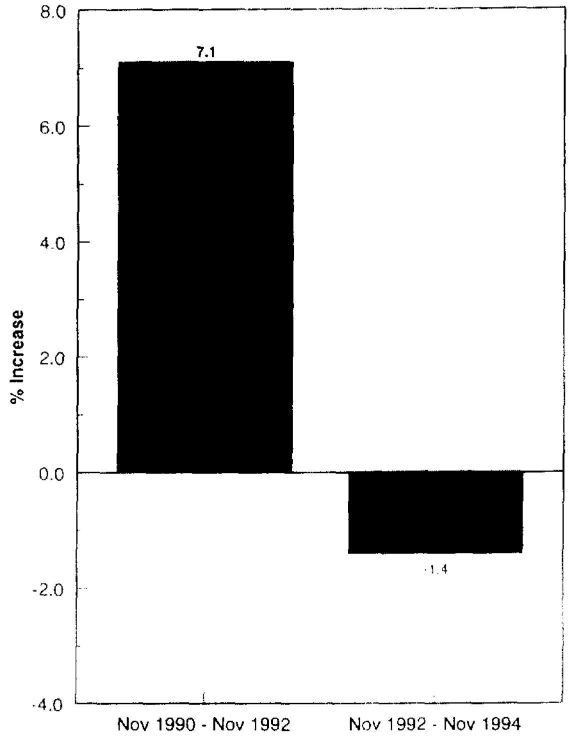
Source: Nielsen Media Research.

however, growth falls to 1.9%. The most dramatic drop from trend is seen in the A.C. Nielsen People Meter. Using a national sample of about 4,000 television households, the data are tracked carefully and continuously by A.C. Nielsen, leading cable programmers to believe it represents a more accurate picture — particularly in tracking short-term changes — than operator-reported subscriber data (which feature considerable lags and discrepancies). The trend break around the time of the 1992 Cable Act in the People Meter numbers (Figure 4) is startling: Despite steady growth in the percentage of households subscribing to cable from 1989, subscriber gains halt as of November 1992. Over the next two years the trend is worse than flat: The 7.1% growth in the 1990-92 period is replaced by a *decline* of 1.4% in the first two years under the Cable Act (Figure 5).

Figure 5

Cable TV Subscriber Growth

Nielsen People Meter Universe Estimates



Source: Nielsen Media Research.

6. Given that the gains from competition are substantial, and that the remedies thus far enacted under the 1992 Cable Act have failed to substantially improve the position of consumers vis-a-vis local cable monopolists, further policy reform is necessary to enhance competitive opportunities. In this light, it is particularly noteworthy that local franchising processes are still in place in structural forms that inevitably act to deter entry into cable markets.[10]

7. The structure of local franchise regulation is inherently anticompetitive because it levies a large and asymmetric burden of proof upon the new entrant applying for a chance to compete.[11]

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[10] Thomas W. Hazlett, "Private Monopoly and the Public Interest: An Economic Analysis of the Cable Television Monopoly," *University of Pennsylvania Law Review 134* (July 1986), pp. 1335-1409.

[11] Thomas W. Hazlett, "Duopolistic Competition in Cable Television: Implications for Public Policy," *Yale Journal on Public Policy VII* (Winter 1990), pp. 65-119.

Rather than treating competitive entry as a right and monopolistic incumbency as a privilege, the system stands consumer welfare logic on its head. Within the standard franchise proceeding, the competitor must prove that *competition* is in the public interest. Until this burden is met, the default position — monopoly — obtains without *any* burden of proof. This process is skewed against the entrant for at least two reasons.

8. The first is that a stand-off in which two parties trade counter-claims with no clear-cut winner results in a *de facto* verdict for the incumbent monopolist. This tilting of the outcome allows the incumbent, therefore, to win by simply raising the cost of information to voters and policymakers: Issuing a host of allegations and challenges to the emergence of competition, (*e.g.*, funding "studies" which purport to show provocative consequences flowing from head-to-head rivalry) makes it less likely that voters and/or their local representatives are going to devote the time and resources necessary to discerning the true consumer effects of entry. In cable markets, incumbent cable firms or city officials partial to monopoly have proven adept at making preposterous anti-competitive arguments in public hearings. One study by the accounting firm Touche Ross in 1987 for the County of Dade, Florida, argued against competition in local cable markets on the grounds that, among other things, consumers would be confused by having to make a choice between firms once the monopoly was ended.[12] A number of such consulting

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[12] Touche Ross, "A Report on Overlapping Cable Franchise Study," Dade County (Florida/Cable Office [7 October, 1987]). The Report was mocked by the *Miami Herald* as a "taxpayer funded study to determine if the bedrock of American Capitalism is a sound principle." ("Comments of Telesat Cablevision, Inc.," in MM Docket 89-600 of the Federal Communications Commission [1 March, 1990], p. 19). The competition never materialized, however the county executive who commissioned the study was hired by TCI to run their Miami, Florida Cable System. "Cable Watchdog Quits to Join Firm." *Miami Herald* (3 November, 1988).

reports in the 1980s routinely advanced the *non sequitur* that, based on their financial projections, competition was infeasible — and should so be prevented by law.[13]

9. The second large advantage enjoyed by incumbents when cities are faced with requests for competitive franchises is the asymmetric nature of anticipated payoffs. Roughly speaking, if the competitor wins, it gains the right to enter a market and realize competitive (or, in cable, perhaps duopolistic) profits.[14] If the monopolist wins, however, it realizes monopoly returns.[15] Hence, the incumbent's incentive and ability to engage in paper-filing, confusion-generating, protectionist activity in efforts to deter the granting of competitive franchises far outweighs what, typically, potential competitors can afford to risk in attempting to obtain them.[16]

10. Imposing the burden of proof on competitive cable entrants also leads to a situation where interests favoring monopoly can use delay tactics as a protective device. That is, where the

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[13] One such widely touted paper was prepared by cable industry consultants Malarkey-Taylor ("Economic Analysis of Cable System Overbuilds," [January 1987]). It was contracted for by Times-Mirror Cable, then fighting an application filed by a potential competitor in a market outside Phoenix, Arizona.

[14] Indeed, the competitor wins only *a* competitive right; by virtue of the actions of the firm to force the issue of competition and set a precedent, other firms might well jump into the market and elect to either overbuild the first new entrant or become the second firm in various submarkets. This raises a free rider issue which also discourages entry. (This has been seen graphically in Sacramento, California where a potential competitor had to sue the County on First Amendment grounds to open up the monopoly franchise. The first firm to actually take advantage of the ruling and overbuild the incumbent was a third firm. See: Thomas W. Hazlett, "Predation in Local Cable TV Markets," *Antitrust Bulletin* ["Cable Predation;" forthcoming, Fall 1995].)

[15] The fact that the incumbent has already sunk specific capital into this market further exacerbates this differential: the monopolist has excess returns *and* quasi-rents at stake.

[16] It is a well known result in the rent-seeking literature that when one party has large advantages in the race for a special privilege, rivals are disinclined to bother competing at all. This explains why the *observed* set of rejected applicants for competitive cable-franchises is likely much smaller than the total set of potential competitors.

newcomer must bear the burden, asking questions and provoking extensive debate can itself stymie competition. In that there is little or no cost incurred by the incumbent in raising controversial issues to be decided publicly, whether in good faith or as an anticompetitive ploy, they will be abundantly supplied. That is because their return is high: So long as unanswered issues remain, the entrant has not met the burden of proof, and monopoly profits continue to flow.

11. The Commission has itself seen the delay tactic as a particularly lethal anticompetitive weapon. In May 1995, the FCC specifically requested that Congress amend the 1992 Cable Act provision which makes it illegal for a municipality to "unreasonably refuse" an applicant a cable franchise. Noting the real world nature of the franchising process, the Commission recommended statutory reform to make it illegal to "unreasonably delay" competitive franchise applications, as well. In the Commission's words: "The added clause will make it clear to local franchising authorities that they cannot evade the pro-competitive intent of the 1992 Cable Act through tactics of delay."[17] What is particularly important here is that, even if the Congress were to legislate and even if the law were to be totally effective in barring cities from unreasonable delays,[18] the law could not reach delays caused by public discussion of controversial issues surrounding the franchise. It is clear that such discussion can effectively be made complex and heated by the strategic input of incumbent operators. Even when run by regulators seeking, in

[17] Federal Communications Commission 1995 Legislative Proposals (May 1995), pp. 1-3.

[18] The likelihood of effective enforcement is low, as the 1992 Cable Act removed any possible damage award against a municipal government which is found to have unreasonably refused a competitive cable franchise.

good faith, to avoid delay, the process can be stretched by private parties exercising their rights to use the franchise process to raise various issues for consideration *ad infinitum*.

12. Within any franchise arrangement, there is the political opportunity for cross subsidies. That is, in exchange for a special privilege, profit-maximizing firms are willing to trade away some fraction of the rents (supra-competitive returns),[19] funding whatever project or group is deemed (politically) worthy. But the less special the privilege, the less generous the franchisee. Hence, industry incumbents and recipients of cross subsidies often have parallel interests in suppressing would-be competitors. Among those who object most strenuously to competitive franchises are independent citizens (not directly associated with the incumbent monopolist) targeted for franchise benefits whom city governments might well desire to subsidize. Yet, in facilitating this transfer via the franchising process, the general class of consumers is subjected to higher prices and/or lower quality service — the result of legally-enforced entry barriers.

13. Often such cross-subsidies become, themselves, entry barriers. This occurs even when entrants are subjected to the same nominal obligations (*i.e.*, subsidy commitments) which the incumbent has undertaken. Indeed, several states now impose statutory requirements on municipalities that cable entrants receive franchises which are no more favorable (but may legally be more onerous) than those held by existing monopoly suppliers. Billed as "level playing field" laws, the cable trade press is far more direct when reporting on such measures to industry insiders: "California Anti-Competition Bill Pending" was one such headline.[20] As an

[19] This is an established element of the economic analysis of regulation. *See:* Richard Posner, "Taxation by Regulation," *Bell Journal on Economics and Management Science* 2 (1971), pp. 22-50.

analytical matter, the *proportional* burden of a *nominally* equal burden is typically higher for an entrant owing to the more competitive situation it faces. When prices are 20% lower and profit margins appropriately slimmer, the opportunity to engage in cross subsidy is much diminished. The same dollar obligation, even if imposed on a per-subscriber (or other *pro rata*) basis, becomes a far less economically plausible commitment for the entrant. This reality not only drives incumbents to favor such "level playing field" laws, but to enlist the active support of community groups which perceive themselves to be recipients of targeted cross subsidies — they correctly see that enhanced market competitiveness lowers the pool of funds available for them. This coalition — incumbents assisted by (subsidized) community groups — has proven an overwhelmingly effective match for upstart competitors forced to shoulder the burden of proof in franchise disputes.

14. The requirement that a second cable entrant provide universal service throughout a franchise area is representative of those burdens which, when attached to second entrants, may have the practical effect of stifling competition and hence hurting consumers. This can be inferred from the enthusiasm which incumbent cable franchisees lobby local and state governments to impose universal service requirements on potential cable entrants, using the franchising process as the means. That the incumbent actually argues to increase the area over which it will compete, expanding the number of lost customers, would violate our assumptions about profit-maximizing behavior were it not for the underlying reality that the incumbent sees such mandates as a way to forestall competition altogether. The cable industry presumption that expensive

[20] Paul Kagan Associates, *Cable TV Franchising* (31 August, 1988), p. 2. *See:* Hazlett, "Cable Predation," *supra*.

franchise requirements are particularly lethal to upstart competitors motivates the otherwise irrational endorsement of universal service mandates

15. The economic disincentive provided entrants by universal service mandates springs from two factors. The first is the simple reality that provision of service at monopoly prices may be feasible where provision of cable service at competitive prices is not. A monopolist may be willing to take on costly burdens due either to the opportunity to charge high prices in each area it serves, or to finance some franchise concessions from monopoly profits generated elsewhere in the franchise area. The second disincentive involves the riskiness associated with a new, competitive venture. The standard means of exploring a new market is to serve some portion of it (typically, the most lucrative) as a means of testing the waters. Once sales sufficient to generate positive profits are realized there, service is expanded to other market segments. (Indeed, the cable television industry has itself developed in this way over the last five decades.) To impose an upfront requirement that no entry can occur anywhere without a commitment to extend service everywhere is to raise risk considerably, particularly in a competitive situation involving dynamic technologies and rapidly changing consumer products. Universal service is typically provided well after the initial investment in technology or competitive organizational forms have well-established both the type of service to be offered and the cost of providing such. This is the rationale behind the FCC's 1990 recommendation that Congress constrain municipalities from imposing build-out requirements on new entrants until they had become sufficiently established to bear such responsibilities.[21]

[21] Federal Communications Commission Report, "In the Matter of Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service," Docket No. 89-600 (Adopted 26 July, 1990), ¶ 141.

16. The fact that cable television service is not universally provided (only about 63% of U.S. households subscribe[22]) nor universally available (about 97% of U.S. households have access to cable[23]) has not stopped cable industry incumbents from alleging that new entrants should have to provide "universal service." Indeed, it has been described as a strategy specifically designed, at industry seminars, to deter "overbuilders." What is clear is that such requirements, imposed via the franchising process, will be used to put additional roadblocks in the path of new competitors attempting to invade local cable TV markets.

17. The testimony of the nation's most aggressive cable overbuilder in recent years, Telesat Cablevision,[24] is revealing. In a 1990 filing with the Federal Communications Commission,[25] Telesat noted that universal service requirements were aggressively lobbied for by cable incumbents when the firm asked a city for a competitive franchise. Often, the company was confronted by heavy burdens as a result. "In Hillsborough County, for example, Telesat is required not only to build out the entire county, but to build out first the most sparsely populated, highest-cost-per-subscriber portions of the franchise area. This requirement was imposed at the behest of Paragon Cable... During the initial 15 or so years Paragon and its predecessors held the franchise in Hillsborough County, they had refused to wire these same areas. When Paragon's franchise was renewed in 1986, no requirement to build out the unwired areas was imposed.

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22 National Cable Television Association, *Cable Television Developments* (Fall 1994), p. 1-A.

23 *Ibid.*

24 Telesat was recently sold by its parent, Florida Power and Light Group Capital, for $112.5 million. It had about 50,000 subscribers, the great majority in competitive cable markets. (Debbie Narod, "Overbuilds '95," *Cable World* [1 May, 1995], p. 48.)

25 "Comments of Telesat Cablevision, Inc.," MM Docket 89-600 (1 March, 1990).

Two years later, newcomer Telesat was required to do so."[26] Of course, even when an expensive franchise requirement was agreed to by Telesat, the process was not over. "After Telesat agrees to such 'build-out' provisions, the incumbent operators nonetheless attack the 'alleged' benefits of competition and assert the nonviability of overbuilding. They offer to 'minimize the demands on the County staff time' by commissioning studies by 'respected analysts.' [footnote omitted] Even before these studies are completed, however, the incumbents hasten to inform the franchising authority of the 'general experience' with competitive franchising."[27] Needless to say, the "respected analysts" show the consequences of consumer choice to be dire, indeed.

18. The legal irony is that the public purposes of the regulation and cross subsidies involved in the local cable franchise are virtually nonexistent. Franchise authorities reliably point to the benefits of monopoly markets and their attendant opportunities for capturing some rents for public use, but the claim is rarely supported by the facts. The most heralded public benefit claimed for cable franchise agreements is support for PEG (public, educational and governmental access) channels, media which are — based on audience share — of little value to ratepayers. Regulatory mandates for such consumer protections as universal service and leased access have largely been observed in the breach. According to perhaps the premier legal expert on telecommunications policy, Henry Geller:

> There has been no flowering of the PEG access channels — only some isolated success stories out of the thousands of cable communities. There is no national access programming for cable. Support for local access varies greatly. C-SPAN, so successful and important on the national level, is far from the norm locally.
>
> Most significantly, the leased access channel provision has been a total failure.[28]

26 *Ibid.*, p. 18.

27 *Ibid.*, p. 16.

The informed view is that such justifications for monopoly franchising are offered as window dressing to protect those who benefit from protectionist regulation.

19. The powerful political influence of defenders of franchise monopoly is a direct result of a classic free rider problem in public policymaking. Whereas the net social benefits of competition are formidable, the gross gains associated with monopoly protection are well targeted. The regulated (franchised) monopoly firm, as well as recipients of cross subsidy, are rationally informed and pro-active on issues involving the local supply of video services. The typical consumer, on the other hand, cannot afford to rationally undertake even an investigation of the matter. This is a product of the wide dispersal of the benefits of competition, juxtaposed to the bunching of benefits to well-defined economic agents under monopoly. Given the distributional and informational advantages of the latter, consumer interests are seriously under-represented in the local franchising process.

20. This is exactly why a 1988 National Telecommunications and Information Administration study found that the municipal franchise had become anticompetitive and anticonsumer:

> The franchising process eliminates or seriously impedes entry by competitors, imposes substantial costs and delays on franchisees, cable subscribers and the public, which are not offset by benefits. The public would be better served by municipal efforts to provide a choice of cable service providers rather than extracting costly concessions from a sole cable franchisee. We therefore recommend that municipalities should permit, even encourage, entry by competitive service providers.[29]

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[28] Henry Geller, *Fiber Optics: An Opportunity for a New Policy?* (Washington, D.C.: Annenberg Washington Program, Communications Policy Studies of Northwestern University; 1991).

[29] NTIA, "Video Program Distribution and Cable Television: Current Policy Issues and

21. One of the great ironies of the municipal franchise in cable television is that, while created pursuant to the police powers enjoyed by local governments over rights-of-way, the franchise typically has almost nothing to do with the use of such easements. Rational regulation of public rights-of-way — making users absorb incremental costs including the expense of mitigating noise, traffic, and citizen inconvenience — is a straightforward administrative matter that may be easily dealt with *without* a franchise. The great bulk of the standard cable TV franchise, on the other hand, concerns issues unrelated to use of rights-of-way, the ostensible reason a cable franchise (which is not a public utility) is issued.

22. It is even more ironic that the original reason for creating rights-of-way throughout a community was to eliminate hold-ups. Because providers of distribution services serve the public via means which require, for efficient delivery, the incidental use of a series of particular properties, any given property owner might be tempted to opportunistically impose an artificial bottleneck, refusing to voluntarily grant access. Hence, public authorities dedicate access over private property in ways designed to limit the inconvenience of owners while enhancing utility for the community as a whole, which benefits from the efficient provision of delivery services. Whatever rules are necessary to prevent cable firms from disrupting the community while accessing such rights-of-way should be generalizable across all users of such rights, including non-monopolistic service providers (construction companies, *e.g.*). Indeed, local public works departments and state public utility commissions routinely establish "rules of the road" to minimize public disruption when rights-of-way are dug up, attached, or otherwise utilized. With

Recommendations" (U.S. Department of Commerce, NTIA Report No. 88-233), pp. 30-31.